

# international tax issues and reporting requirements

Foreign income exclusions and foreign tax credits can significantly reduce the taxes you pay on foreign sourced income and help you avoid double taxation. Complex reporting is required for U.S. persons to disclose foreign holdings and bank accounts, to avoid severe penalties for non-compliance.



## FOREIGN TAX ISSUES

With globalization, multinational clients with cross-border income from employment and investments are in today's mainstream. Many taxpayers are discovering that they are subject to taxation in both U.S. and foreign tax jurisdictions. Not all U.S. citizens and resident aliens are aware of their obligation to report their worldwide income to the Internal Revenue Service. As a result, the United States continues to pursue U.S. persons who fail to report income and file certain tax forms. These complex issues not only impact you if you are on an overseas assignment or retired abroad, but have broad reaching implications even if you never have left the United States. For instance, these issues arise if you invest in hedge funds, private equity funds, and other entities that own interests in foreign operating businesses or invest in foreign securities.

Significant legislation enacted in 2010 imposes a new U.S. withholding regime for income earned by non-U.S. persons (effective beginning in 2013) and tightens the reporting requirements for offshore accounts and entities set up in foreign jurisdictions including increased disclosure of beneficial owners, reporting of the transfer of assets, and imposition of a punitive penalty regime for not reporting transactions with foreign trusts.

This chapter is intended to provide an overview of the income exclusions, foreign tax credits, reporting requirements, and elections involving foreign employment and investments. A section dedicated to U.S. taxation of non-resident individuals

is featured in this year's guide. However, it does not consider the special tax elections associated with a foreigner's move to the United States or foreign currency transactions.

## FOREIGN EARNED INCOME EXCLUSION AND FOREIGN HOUSING EXCLUSION/DEDUCTION

In general, the worldwide income of a U.S. citizen or resident who is working abroad is subject to the same income tax and return filing requirements that apply to U.S. citizens or residents living in the United States. However, if you are working abroad, you may qualify for one or more special tax benefits:

- Exclude up to \$92,900 in 2011 and \$95,100 in 2012 in foreign earned income.
- Exclude part, or all, of any housing income reimbursements you receive or deduct part, or all, of any housing costs paid (i.e., for taxpayers having salary or self-employment earnings).
- Claim a foreign tax credit against your U.S. tax liability for income taxes you pay to a foreign country, or alternatively, take an itemized deduction for the taxes paid if more beneficial.
- Reduce your overall tax liability under tax treaties that the U.S. has with foreign countries.

### tax tip

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## TAX BENEFITS OF THE FOREIGN EARNED INCOME AND HOUSING EXCLUSIONS

For example, your company sends you to work in Dubai in 2011 for several years, so you qualify as a bona fide resident of the UAE based on your time spent in Dubai. Assume you earn \$500,000 per year and your company reimburses you for \$125,000 of housing costs which are taxable to you. You would be able to exclude the following income from your U.S. income tax return:

- \$92,900 of your salary.
- \$42,310 of the housing expense reimbursements.

The 2011 foreign earned income maximum is \$92,900, regardless of which foreign country you are working in. The housing exclusion is based on which country and city you are living in (see Chart 13 for

some of the more common foreign cities).

Dubai is considered to be an expensive city to live in, so the annual housing exclusion amount is \$57,174. Of this amount, you are not eligible to exclude \$40.72 per day, or \$14,864 for a full year. Therefore, your 2011 housing exclusion will be \$42,310 (\$57,174 - \$14,864). When added to your foreign earned income exclusion of \$92,900, you can exclude a total of \$135,210.

Therefore, you will be taxed in the United States on \$489,790 related to your employment in Dubai (\$500,000 compensation plus \$125,000 housing cost reimbursements less the exclusions of \$135,210).

*Note: To the extent you pay income taxes to the foreign country you may also be eligible to receive a foreign tax credit against the U.S. tax imposed on the remaining income. However, only 78.36% of these taxes will be allowable as a foreign tax credit that can offset your U.S. income tax (i.e., only \$489,790 of the total \$625,000 of income will be subject to tax: \$489,790 divided by \$625,000 is 78.36%).*

*As you can see in Tax Tip 26, your foreign housing exclusion might be limited depending on where you live. In order to see the differences in limits for housing deductions in 2011, see Chart 13 on the next page.*

chart

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## FOREIGN HOUSING EXCLUSIONS

The amount of foreign housing exclusions costs that you can exclude from your 2011 U.S. income tax return depends on both the country and city you are living in. Below are listed the maximum amounts you can exclude for some common foreign cities, before the adjustment for the daily living cost of \$40.72 per day, or \$14,864 for a full year.

Country	City	Maximum Annual Housing Exclusion
Canada	Toronto	\$ 51,100
China	Hong Kong Beijing	114,300 71,200
France	Paris	84,800
Germany	Berlin	50,800
India	New Delhi	30,252
Italy	Rome	56,500
Japan	Tokyo	118,500
Russia	Moscow	108,000
Switzerland	Zurich	39,219
United Arab Emirates	Dubai	57,174
United Kingdom	London	83,400

- Take an exemption from paying Social Security tax in the foreign country based on a Totalization Agreement the U.S. has with some foreign countries to eliminate dual coverage for the same work. You will be required to pay U.S. Social Security and Medicare tax on such income.

To qualify for the foreign earned income exclusion and the foreign housing exclusion, you must establish a tax home in a foreign country and meet either the bona fide residence or physical presence test, defined below:

- **Bona fide residence test.** To qualify under this test, you must establish residency in a foreign country for an uninterrupted period that includes an entire calendar year. Brief trips outside the foreign country will not risk your status as a bona fide

resident, as long as the trips are brief, and there is an intent to return to the foreign country.

- **Physical presence test.** This test requires you to be physically present in a foreign country for at least 330 full days in a consecutive 12-month period, but not necessarily a calendar year period.

#### Planning Tip.

In certain circumstances it may be more beneficial to forego the exclusion in favor of claiming only a foreign tax credit. If you pay no foreign tax or the effective tax rate in the foreign jurisdiction is lower than the U.S. tax rate, claiming the exclusion will generally lower the U.S. income tax liability. On the other hand, if the foreign jurisdiction imposes tax at a higher effective rate than the U.S.,

it is likely that the U.S. tax on the foreign earned income will be completely offset by the foreign tax credit regardless of whether the exclusion is claimed. You should consider whether foregoing the exclusion may result in a lower utilization of foreign tax credits in the current year so that a larger amount of foreign tax credits can be carried back or forward for utilization in other years. You should also consider whether the foreign earned income exclusion and housing exclusion election will mitigate your state tax burden to the extent that you have ceased to be a state resident and you remain taxable on worldwide income in the state of residency.

Claiming the exclusion is a binding election. Once you have claimed the benefit of the exclusion in a tax year, you will be required to continue to claim it in all future years. You will be able to revoke the election, but having done so, you will not be allowed to claim the exclusion again until the sixth tax year after the year of revocation unless you receive permission from the IRS. If you have claimed the exclusion in the past, the benefit of revoking the exclusion must be weighed against the possible ramifications of being unable to re-elect the exclusion for five years. There is no downside of forgoing the exclusion if you have never claimed it in the past.

## FOREIGN TAX CREDIT

A foreign tax credit may be claimed by U.S. citizens, resident aliens, and in certain cases by nonresident aliens. Typically states do not allow foreign tax to offset state income tax liability. Unlike the exclusions discussed above, you do not need to live or work in a foreign country in order to be eligible to claim the foreign tax credit. If you pay, or accrue, foreign taxes on foreign sourced income, you may be eligible for the credit.

Common examples of foreign sourced income that may generate foreign taxes include dividends paid by foreign corporations, including those paid on your behalf through mutual fund, and foreign business income earned by a flow-through entity.

You are entitled to claim either a tax credit or an itemized deduction for taxes paid to foreign countries. Though not always the case, the tax credit is more beneficial since it reduces your U.S. federal tax liability on a dollar-for-dollar basis.

Generally, only foreign income taxes qualify for the foreign tax credit. Other taxes, such as foreign real and personal property taxes, do not qualify. However, these other taxes may still be deductible as itemized deductions on your U.S. income tax return. There are other situations which may prevent you from taking a foreign tax credit:

- Taxes paid on income excluded from U.S. gross income

(e.g., foreign earned income exclusion).

- Taxes paid to international boycott operations countries.
- Taxes of U.S. persons controlling foreign corporations and partnerships if certain annual international returns are not filed.
- Certain taxes paid on foreign oil-related, mineral, and oil and gas extraction income.

Your ability to claim a credit for the full amount of foreign taxes paid or accrued is limited based on a ratio of your foreign source taxable income to your total taxable income. This ratio is applied to your actual tax before the credit to determine the maximum amount of the credit that you can claim. If you are not able to claim the full amount of the credit in the current year, you can carry the excess back to the immediately preceding tax year, or forward for the next 10 tax years, subject to a similar limitation in those years.

The credit calculation is done for each separate type of foreign source income. In other words, foreign taxes paid on dividends are subject to a separate limitation than foreign taxes paid on income from an active trade or business. Foreign sourced income is classified into two different baskets for determining the allowable credit:

- Passive income: This category includes dividends, interest, rents, royalties, and annuities.
- General limitation income: This category includes income from foreign sources which does not fall into the passive separate limitation category and generally is income earned from salary, pensions or an active trade or business.

Beginning in 2012, you will be required to maintain a separate foreign tax credit limitation basket for each country in which income is resourced under an income tax treaty. This provision will apply to income classified as U.S. sourced income under U.S. tax law, but treated as foreign sourced income under an income tax treaty resourcing article (an example would be the United Kingdom).

## EXPATRIATION EXIT TAX

If you plan on giving up your U.S. citizenship or relinquishing your U.S. legal permanent residency status ("green card") and are considered a "covered expatriate," you will pay an income tax at the capital gains rate as though you have sold all of your assets at their fair market value on the day before the expatriation date and any gain on the deemed sale in excess of a floor, of \$636,000 for 2011 and \$651,000 for 2012, is immediately taxed ("mark-to-market tax").

Losses are taken into account and the wash sale rules do not apply. An election can be made to defer the tax on the deemed sale until the asset is actually sold (or death, if sooner) provided a bond or other security is provided to the IRS. Deferred compensation items and interests in non-grantor trusts are not subject to the tax but are generally subject to a 30% withholding tax on distributions to the expatriate. Individual Retirement Accounts and certain other tax-deferred accounts are treated as if they were completely distributed on the day before the expatriation date with no early distribution penalties to be applied.

The tax applies to an expatriate or former long-term resident (i.e., holder of a U.S. green card for eight out of the last 15 years) who:

- Had average annual net income tax liability for the five years ending before the date of expatriation or termination of residency in excess of an annual ceiling, which for 2011 is \$147,000 and \$151,000 for 2012;
- Had a net worth of \$2 million or more when citizenship or residency ended; or
- Fails to certify compliance under penalties of perjury on Form 8854, Initial and Annual Expatriation Statement, with all U.S. federal tax obligations for the five tax years preceding the date of expatriation.

A U.S. citizen or resident will have to pay tax on a gift or bequest received from an individual who had expatriated after June 17, 2008. The tax does not apply to the extent that the gift or bequest during the year is within the annual gift tax exclusion (\$13,000 for 2011 and 2012). The tax does not apply if the transfer is reported on a timely filed gift tax return or estate tax return or to transfers that qualify for the marital or charitable deductions. The value of a transfer not covered by an exception is taxable to the recipient at the highest rate on taxable gifts, which is 35% for 2011.

## U.S. INCOME TAXATION OF NONRESIDENT INDIVIDUALS

Residents and non-residents are taxed differently for U.S. tax purposes. Resident aliens are taxed on worldwide income at graduated tax rates much the same as a U.S. citizen. A non-resident alien, however, is taxed at graduated rates only on income that is effectively connected with a U.S. trade or business or at a 30% rate on U.S. source income that is not effectively connected with a U.S. trade or business (unless a lower income tax treaty rate applies).

A foreign national is deemed a resident alien of the U.S. if one of the two following tests are met:

- Lawful permanent residence (green card test); or
- Substantial presence test.

If you are physically present in the United States for at least 31 days during 2011 and have spent 183 days during the period of 2011, 2010, and 2009 counting all of the days of physical presence in 2011, but only  $\frac{1}{3}$  of the days of presence in 2010, and only  $\frac{1}{6}$  of the number of days in 2009 you will be deemed a resident for U.S. tax purposes.

You are treated as being present in the U.S. on any day that you are physically present in the country at any time during the day, though time spent in the U.S. for the following circumstances do not count:

1. Days you regularly commute to work in the United States from a residence in Canada or Mexico.
2. Days you were in the United States for less than 24 hours when you were traveling between two places outside the United States.
3. Days you were temporarily in the United States as a regular crew member of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States unless you otherwise engaged in trade or business on such a day.
4. Days you were unable to leave the United States because of a medical condition or medical problem that arose while you were in the United States.
5. Days you were an exempt individual (e.g., foreign government-related individual, teacher or trainee, student or a professional athlete competing in a charitable sporting event).

Note: If you qualify to exclude days of presence in the United States because you were an exempt individual (other than a foreign government-related individual) or because of a medical condition or medical problem, you must file Form 8843, Statement for Exempt Individuals and Individuals With a Medical Condition.

Even though you would otherwise meet the substantial presence test, you will not be treated as a U.S. resident for 2011 if:

- You were present in the United States for fewer than 183 days during the calendar year in question,
- You establish that during that calendar year, you had a tax home in a foreign country, and
- You establish that during the calendar year, you had a closer

connection to one foreign country in which you had a tax home than to the United States, unless you had a closer connection to two foreign countries.

You will be considered to have a closer connection to a foreign country other than to the United States if you or the IRS establishes that you have maintained more significant contacts with the foreign country than with the United States.

IRS Form 8840, Closer Connection Exception Statement for Aliens, will need to be submitted with your U.S. non-resident income tax return for the year in which you meet the physical presence test and you are exempt from it because you also meet the closer connection test.

Alternatively, you may be considered a non-resident if you also would qualify as a resident of your home jurisdiction under the Tie Breaker Clause of an income tax treaty with the U.S.

There are certain elections available to non-residents who move to the United States that when considered could minimize global taxation. These elections are beyond the scope of this chapter.

## U.S. REPORTING REQUIREMENTS FOR NON-RESIDENT ALIENS

### Form 1040NR / 1040NR-EZ

This tax form is used by non-residents of the U.S. to report on an annual basis the income received from U.S. sources and the payments of U.S. tax, made either through withholding by the payor or through estimated tax payments. The U.S. tax liability for the year is computed and any tax due in excess of payments made during the year is remitted to the U.S. Treasury. A U.S. non-resident may be subject to state income tax on the income earned in that jurisdiction.

### Form 1042-S

If you are a foreign national, classified as a nonresident of the U.S. and receive payments from U.S. sources, you will receive Form 1042-S. This is the annual information return prepared by the payor to report to you and the IRS each foreign recipient's name, address, amount and type of income paid and taxes withheld, if any. This form is normally distributed no later than March 15 of the following year. If the recipient of the income is a U.S. person, a 1099 form would be issued instead; Forms 1099 are due to be received by U.S. persons no later than January 31 of the following year.

### Form W-8

This form is provided by a foreign recipient to a payor to certify the recipient's tax residency and status as beneficial owner of the income paid. If applicable, this form should be completed to claim

the benefits of an income tax treaty.

## FOREIGN REPORTING REQUIREMENTS FOR U.S. CITIZEN AND RESIDENTS

There are many IRS tax forms that must be completed and attached to your tax return to disclose foreign holdings and to make elections that could prove valuable to you in the future. As more and more of your investments include foreign holdings, whether held directly by you or through a pass-through entity such as an investment partnership or hedge fund, your reporting requirements increase. These requirements place an additional burden on the amount of information that you must include with your income tax return. Failure to do so could result in substantial penalties and the loss of beneficial tax elections. The most common of these forms are:

- Form TDF 90-22.1, Report of Foreign Bank and Financial Accounts.
- Form 8621, Return by a Shareholder of a Passive Foreign Investment Company (PFIC) or Qualified Electing Fund (QEF).
- Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation.
- Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships.
- Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations.
- Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.
- Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner.

## FORM TDF 90-22.1, REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS

If you are a United States person (including a corporation, partnership, exempt organization, trust or estate) and have a financial interest in or signature authority over a foreign financial account, you are subject to a reporting requirement on Form TDF 90-22.1, Report of Foreign Bank and Financial Accounts ("FBAR").

The FBAR must be filed on an annual basis if you have a financial interest in or signature authority over a financial account(s) in a foreign country with an aggregate value of the financial account(s) exceeding \$10,000 at any time during the year. The

report is due on June 30 of each succeeding year. There are no extensions available for filing the form.

Financial accounts include any bank, securities, derivatives, foreign mutual funds or other financial accounts (including any savings, demand, checking, deposit, annuity, or life insurance contract or other account maintained with a financial institution). The IRS issued final regulations suspending the reporting of offshore commingled funds, such as hedge funds and private equity funds.

A financial interest in an account includes being the owner of record or having legal title, even if acting as an agent, nominee, or in some other capacity on behalf of a United States person. A financial interest also includes an account held by a corporation in which you own, directly or indirectly, more than 50% of the total voting power or value of shares; a partnership in which you own an interest of more than 50% in the capital or profits; or a trust as to which you or any other United States person has a present beneficial interest in more than 50% of the assets or receives more than 50% of the current income.

In the case of a non-willful failure to file the FBAR, the IRS may impose a maximum penalty of \$10,000 per account. The maximum penalty imposed where there is willfulness is the greater of \$100,000 or 50% of the highest balance in the account during the year. Criminal penalties could also be assessed for willful violations.

In 2011, the IRS offered an Offshore Voluntary Disclosure Initiative ("OVDI") that provided an opportunity for taxpayers to come forward and disclose unreported foreign income and file informational returns while paying a lower penalty and avoiding criminal prosecution. Although this initiative has come to an end, the IRS has a long-standing voluntary disclosure program available to taxpayers who wish to disclose voluntarily foreign financial accounts, income or assets that have previously not been reported. As of the date of publishing, there is no indication that a special voluntary disclosure program similar to the 2011 OVDI will be offered by the IRS in the near future.

### FORM 8621, RETURN BY A SHAREHOLDER OF A PASSIVE FOREIGN INVESTMENT COMPANY (PFIC) OR QUALIFIED ELECTING FUND (QEF)

Any U.S. person who invests in a foreign corporation which is a passive foreign investment company ("PFIC") must pay tax on gains from the sale of the investment or on certain distributions from the PFIC ("triggering event"), unless a qualified electing fund ("QEF") election or mark-to-market election is made. If neither of these two elections are made, the PFIC rules require a ratable allocation of any gain over the years during which the shares were held and that gain is taxed at the highest rate on ordinary income

in effect for each of the years involved, rather than the beneficial long-term capital gains rate in the year of disposition. An interest charge is also imposed on the tax, and begins running from the period to which such gain is allocated. In certain situations, this tax can exceed 100% of the gain.

Classification as a PFIC occurs when 75% or more of the corporation's income is passive or when more than 50% of the corporation's assets generate passive income. Passive income includes, but is not limited to, interest, dividends, and capital gains.

A U.S. shareholder who makes the QEF election on Form 8621 is required to annually include in income the pro rata share of the ordinary earnings and net capital gains of the corporation, whether or not distributed, but can avoid the onerous PFIC tax.

Alternatively, a shareholder of a PFIC may make a mark-to-market election on Form 8621 for marketable PFIC stock. If the election is made, the shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the tax year over the shareholder's adjusted basis in the stock or deducts the excess of the PFIC stock's adjusted basis over its fair market value at the close of the tax year (the deduction is limited to prior cumulative income pickups). If the election is made, the PFIC rules above do not apply. Amounts included in income or deducted under the mark-to-market election, as well as gain or loss on the actual sale or other disposition of the PFIC stock, are treated as ordinary income or loss.

Taxpayers owning PFICs are now required to file the Form 8621 regardless of whether a triggering event has occurred or an election has been made. However, the IRS issued guidance suspending the information reporting requirements for tax years beginning after March 17, 2010 until the IRS releases revised Form 8621. PFIC shareholders will be required to attach the form for the suspended tax year to the following year's income tax return required to be filed.

### FORM 926, RETURN BY A U.S. TRANSFEROR OF PROPERTY TO A FOREIGN CORPORATION

Form 926 is used to report certain transfers of tangible or intangible property to a foreign corporation. While there are certain exceptions to the filing, generally the following special rules apply to reportable transfers:

- If the transferor is a partnership, the U.S. partners of the partnership, not the partnership itself, are required to report the transfer on Form 926 based on the partner's proportionate share of the transferred property.



- If the transfer includes cash, the transfer is reportable on Form 926 if immediately after the transfer the person holds, directly or indirectly, at least 10% of the total voting power or the total value of the foreign corporation, or the amount of cash transferred by the person to the foreign corporation during the 12-month period ending on the date of the transfer exceeds \$100,000.

The penalty for failure to comply with the reporting requirements is equal to 10% of the fair market value of the property at the time of the transfer, limited to \$100,000 unless the failure to comply was due to intentional disregard.

## FORM 8865, RETURN OF U.S. PERSONS WITH RESPECT TO CERTAIN FOREIGN PARTNERSHIPS

Form 8865 is required to report information with respect to controlled foreign partnerships, transfers to foreign partnerships, or acquisitions, dispositions, and changes in foreign partnership ownership. A separate Form 8865, along with the applicable schedules, is required for each foreign partnership.

There are four different categories which define who is required to file the form and how much information must be provided. The categories are:

- **Category 1:** A U.S. person who owned more than a 50% interest in a foreign partnership at any time during the partnership's tax year.
- **Category 2:** A U.S. person who at any time during the tax year of the foreign partnership owned a 10% or greater interest in the partnership while the partnership was controlled by U.S. persons each owing at least 10% interests. However, if there was a Category 1 filer at any time during that tax year, no person will be considered a Category 2 filer.
- **Category 3:** A U.S. person, including a related person, who contributed property during that person's tax year to a foreign partnership in exchange for an interest in the partnership, if that person either owned directly or indirectly at least a 10% interest in the foreign partnership immediately after the contribution, or the value of the property contributed by such person or related person exceeds \$100,000. If a domestic partnership contributes property to a foreign partnership, the partners are considered to have transferred a proportionate share of the contributed property to the foreign partnership. However, if the domestic partnership files Form 8865 and properly reports all the required information with respect to the contribution, its partners will generally not be required to report the transfer.

- **Category 4:** A U.S. person who had one of the following reportable events during the tax year: an acquisition, disposition, or change in proportional interests. There are specific requirements to determine whether any of the events are reportable.

A penalty of \$10,000 can be assessed for failure to furnish the required information within the time prescribed. This penalty is applied for each tax year of each foreign partnership. Furthermore, once the IRS has sent out a notification of the failure to report the information, an additional \$10,000 penalty can be assessed for each 30-day period that the failure continues, up to a maximum of \$50,000 for each failure.

## FORM 5471, INFORMATION RETURN OF U.S. PERSONS WITH RESPECT TO CERTAIN FOREIGN CORPORATIONS

Form 5471 is used to satisfy the reporting requirement for U.S. persons who are officers, directors, or shareholders in certain foreign corporations. You will be required to file this form if you meet one of the following tests (**Category 1 has been repealed**):

- **Category 2:** You are a U.S. person who is an officer or director of a foreign corporation in which a U.S. person has acquired stock that makes him or her a 10% owner with respect to the foreign corporation, or acquired an additional 10% or more of the outstanding stock of the foreign corporation
- **Category 3:** You are a U.S. person who acquires stock in a foreign corporation which, when added to any stock owned on the date of acquisition or without regard to stock already owned, meets the 10% stock ownership requirement with respect to the foreign corporation, or
  - You are a person who becomes a U.S. person while meeting the 10% stock ownership requirement with respect to the foreign corporation.
  - You are a U.S. person who disposes of sufficient stock in the foreign corporation to reduce your interest to less than the 10% stock ownership requirement.
- **Category 4:** You are a U.S. shareholder who owns more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of the stock in a foreign corporation for an uninterrupted period of 30 days or more during any tax year of the foreign corporation.
- **Category 5:** You are a U.S. shareholder who owns stock in a controlled foreign corporation ("CFC") for an uninterrupted period of 30 days or more and who owns the stock on the last



day of that year. A CFC is defined as a foreign corporation that has U.S. shareholders (counting only those with a 10 percent interest) that own on any day of the tax year of the foreign corporation more than 50% of the total combined voting power of all classes of its voting stock, or the total value of the stock of the corporation.

*Note: In determining stock ownership for these purposes, certain constructive ownership rules apply.*

The same penalties that apply for failure to file Form 8865 also apply to Form 5471 (see the discussion in the previous section). The information required to properly complete the Form 5471 can be extensive and difficult to obtain.

### FORM 3520, ANNUAL RETURN TO REPORT TRANSACTIONS WITH FOREIGN TRUSTS AND RECEIPT OF CERTAIN FOREIGN GIFTS AND FORM 3520-A, ANNUAL INFORMATION RETURN OF FOREIGN TRUST WITH A U.S. OWNER

U.S. persons who either create a foreign trust, receive distributions from a foreign trust, or receive gifts or bequests from foreign persons are required to file the Form 3520.

A foreign trust is defined as a trust in which either a court outside of the United States is able to exercise primary supervision over the administration of the trust or one or more non-U.S. persons have the authority to control all substantial decisions of the trust.

The information return must be filed in connection with the formation of a foreign trust, the transfer of cash or other assets by the settlor or grantor to a foreign trust, and the receipt of any distributions by a U.S. beneficiary from a foreign trust. Any uncompensated use of foreign trust property (e.g., real estate or personal property) by a U.S. grantor, U.S. beneficiary, or any related person is treated as a distribution to the grantor or beneficiary equal to the fair market value of the use of the property and must be reported. The use or loan of trust property will not be considered a distribution to the extent the loan is repaid with a market rate interest or the user makes a payment equal to the fair market value of such use within a reasonable time frame.

Gifts or bequests that you receive in the form of money or property from a foreigner (including a foreign estate) that is valued in the aggregate at more than \$100,000 annually is required to be reported. Gifts in 2011 in excess of \$14,375 (or \$14,723 in 2012) from a foreign corporation or foreign partnership that you treat as a gift must also be disclosed.

The Form 3520 must be filed by the due date of your individual

income tax return, including extensions. The failure to do so may subject you to a penalty of 35% of the gross value of any property transferred to the trust, 35% of the gross value of the distributions received from the trust, or 5% of the amount of certain foreign gifts for each month for which the gift goes unreported (not to exceed 25% of the gift).

In addition to the filing requirements of the Form 3520, there is also a requirement to file a Form 3520-A (Annual Information Return of Foreign Trust With a U.S. Owner) which is an annual information return of a foreign trust with at least one U.S. owner and which is considered a grantor trust. If you are a U.S. person who directly or indirectly transfers property to a foreign trust, the trust is presumed to have a U.S. beneficiary and is considered a grantor trust unless you can demonstrate that under the terms of the agreement, no income or corpus of the trust can be paid or accumulated for the benefit of a U.S. person. As the U.S. owner, you are responsible for ensuring that the foreign trust annually furnishes certain information to the Internal Revenue Service and the other owners and beneficiaries of the trust.

The Form 3520-A must be filed by March 15 after the foreign trust's tax year, in the case of a calendar year trust. A six-month extension can be requested on IRS Form 7004.

### FORM 8938, STATEMENT OF FOREIGN FINANCIAL ASSETS

For tax years beginning after March 18, 2010, U.S. citizens or resident aliens who hold more than \$50,000 (in the aggregate) in certain foreign assets (e.g., a foreign financial account, an interest in a foreign entity, or any financial instrument or contract held for investment that is held and issued by a foreigner) will be required to report information about those assets on an income tax return using Form 8938, Statement of Foreign Financial Assets. This requirement is in addition to the FBAR reporting.

Noncompliance with these rules for any tax year will result in a minimum failure to file penalty of \$10,000 and continuing failure to file penalties up to a maximum of \$50,000. In addition a 40% understatement penalty for underpayment of tax as a result of a transaction involving an undisclosed specified foreign financial asset and criminal penalties may apply.

For tax returns filed after March 18, 2010, the statute of limitations for assessing tax with regard to cross-border transactions or for certain foreign assets will be extended for 3 years from the date certain informational reporting is submitted related to the transaction or the asset if the failure to report was due to reasonable cause and not willful omission. If an omission is in excess of \$5,000 related to a foreign financial asset, the statute of limitations will be extended

from 3 years to 6 years and would not begin to run until the taxpayer files the return disclosing the reportable foreign asset.

NOTE: The IRS issued guidance suspending the information reporting requirements for tax years beginning after March 18, 2010 until the IRS releases the Form 8938. U.S. persons will be required to attach the form for the suspended tax year to the following year's income tax return required to be filed.

Form 8938 filed for a suspended taxable year with a timely filed income tax or information return (taking into account extensions) will be treated as having been filed on the date that the income tax or information return for the suspended taxable year was filed.

**Observation:** *The definition of reportable foreign asset is much broader than under the FBAR rules and includes interests in offshore hedge fund and private equity funds.*

*Individuals not required to file a U.S. income tax return for the tax year are not required to file Form 8938 even if the aggregate value of the specified foreign financial assets is more than the appropriate reporting threshold.*

Beginning In 2014 foreign financial institutions will be required to report directly to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. To properly comply, a foreign financial institution will have to enter into a special agreement with the IRS by June 30, 2013. A participating institution will be required to implement certain account opening procedures, to identify U.S. accounts opened on or after the effective date of the agreement, and to have certain procedures for pre-existing private banking accounts. The U.S. account holder will need to provide the institution a Form W-9 to identify the status as a U.S. account holder and the institution will report the information to the IRS. Those institutions that do not participate and account owners unwilling to provide information will be subject to a 30% withholding tax on certain U.S. source payments including interest, dividends and proceeds from the sale of securities.